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US Macroeconomics

May 25, 2023

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What's Changed?

Over the past two weeks, **the bond market has sold off sharply**. At the time of this writing, the 2-year treasury note, which is closely tethered to the path of monetary policy has risen 53 basis points (bps) to 4.43%. This reflects a major shift in Fed expectations.

The futures market now assigns a near 50% probability of a 25 bp June 14 rate increase or roughly an 80% probability the Fed delivers on that at the July 26 FOMC meeting.

Remember that just a few weeks ago, the bond market was expecting a July rate cut with more to follow. Now, the market expects just one 25 bps cut and only in December.

The dramatic sell off in 2-year notes has coincided with a less dramatic but still large increase in 10-year notes. Their yield has risen 37 bps to 3.75%, the highest since March 9. In the process, the 2s/10s curve, our favorite yield curve measure, has inverted 20 bps to -67 bps.

The persistence of this inversion, which began last July, is expected to continue to weigh on money and credit creation. And it will continue to be a negative factor for many banks who depend on short-term rates (their cost of funding), being below long-term rates (their return on investment). So, what fundamentally has changed in the last couple of weeks?

The short answer is not much. Jobless claims are lower because of a correction in prior reporting but their trend still grinds higher. The housing market data — NAHB, mortgage applications, etcetera— have improved but this probably was to be expected after eight quarters in a row in which residential investment declined. The question is whether the recent bounce is sustainable.

Given high mortgage rates and tighter residential lending standards, we doubt it. The regional purchasing managers surveys (NY, Philadelphia, Richmond) remain atrocious. Manufacturing remains in recession against the backdrop of weakening global demand. In the last couple of days, commodity prices broke lower through a key support level. Industrially sensitive copper prices are moving back down.

Admittedly, some of the inflation data has been mixed-to-higher. The Q1 GDP deflator and core PCE figures were revised slightly higher**,** but this is old news. Forward-looking measures of inflation such as breakevens and 5y/5y inflation swaps remain relatively low and stable. Price expectations are anchored.

While our view is that the economic fundamentals have not changed, the equity market has held firm. Since the bond sell-off began, the broad market is trading near the high end of its range while the NASDAQ has increased nearly 3%. Perhaps this ebullience is impacting the bond market's (and Fed policymakers') expectations of what happens next. If it does, and the Fed is not yet done hiking interest rates, investors should become more**,** not less, worried about the economic outlook. Stay tuned.

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